



Federal Accounting Standards Advisory Board

November 6, 2006

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Conceptual Framework: Elements. The Qualitative Characteristics of Accounting Information—TAB G—Paper 1**

<p>NOTE: FASAB staff prepares memos and other materials to facilitate discussion of issues at Board meetings. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.</p>
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Question No. 10 in the Questions for Respondents included in the Elements Exposure Draft (ED) issued in June 2006 asked whether respondents agree with “the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for a consideration of the qualitative characteristics of financial information as part of determining whether an item meets the recognition criteria.” The recognition criteria proposed in the ED are that an item should meet the definition of an element and should be measurable, which is defined in the ED as “quantifiable in monetary units” (par. 5).

To place the question in context, the first paragraph of the preamble to Question 10 explains that the proposed Concepts Statement takes the position that the qualitative characteristics and their role in financial reporting are defined in SFFAC 1, *Objectives of Federal Financial Reporting* and are not altered by the proposed Concepts Statement; to repeat the qualitative characteristics in the proposal would not be useful and could cause confusion regarding the status and application of the characteristics. Further, if the application of the characteristics requires explanation, the explanation should be approached in a comprehensive manner. The second paragraph of the preamble to Question 10 explains that members with an alternative view believe that the proposed Concepts Statement “should require a consideration of all of the qualitative characteristics of financial reporting in determining whether an item meets the recognition criteria; i.e. meets the definition and is measurable.” The complete text of Question 10, including the preamble, is at the end of this memo.

RESPONSES

As reported in the staff summary of responses presented at the September 2006 FASAB meeting, 12 respondents (6 auditors, 5 non-federal other, and 1 federal preparer) say they support the position in the proposed Concepts Statement and 16 respondents (11 federal preparers and 5 federal auditors) say they support the alternative view. (Three respondents do not answer the question.) These are summary groupings of the responses and the reasons given vary.

Respondents who support the ED position often give the reasons included in the first paragraph of Question 10. For example:

[We] agree with the proposed Concepts Statement and the members' rationale for not repeating the characteristics in this document. [025—Federal Auditor]

We agree with the position taken in the proposed Concepts Statement. The characteristics are implied and do not need to be repeated. [026—Non-federal Other]

If already published and not changed by this Concepts Statement, including the qualitative characteristics is unnecessary and confusing. The Concept Statement, to be effective, should limit itself to the specific subject of the concept. Including it in the Concept Statement would serve the same purpose as the specific inclusion of probability. [022—Non-federal Other]

We agree with the position taken in the proposed Concepts Statement. We interpret SFFAC 1 to mean that overall the information in financial reports should have those qualitative characteristics. Some information by its nature may be difficult for readers to understand or may not seem relevant to them, but may in fact be required for complete financial reporting. Although the qualitative characteristics should be taken into account when making decisions as to what to include in financial statements, we do not believe those characteristics need to be repeated in this Concepts Statement. Nonetheless, it may be helpful to include some type of reference to SFFAC 1. [006—Federal Auditor]

Other respondents who support the ED position indicate that they do not agree that the concepts statement should require application of the qualitative characteristics when considering whether an item meets the recognition criteria. For example:

We disagree with the Alternative View that qualitative characteristics should be considered in determining whether management should recognize an item in the financial statements. The characteristics in SFFAC 1 relate to the statements taken as a whole. We don't believe these necessarily relate to whether or not individual components are recognized in the financial statements. [027—Federal Auditor]

We agree with the proposed Concept Statement. We do not believe that a consideration of the qualitative characteristics of financial reporting is required in determining whether an item meets the recognition criteria. [011—Non-federal Other]

We agree with the position taken in the proposed Statement. We do not believe that failure to include the qualitative characteristics will result in erroneous recognition and

agree that repeating the qualitative characteristics runs the risk of causing confusion about their application. [029—Federal Preparer]

We agree with the proposed Concepts Statement. Implicit in the recognition criteria are the six characteristics of: understandability, reliability, relevance, timeliness, consistency, and comparability. These characteristics do not have to be explicitly stated in the recognition criteria. They are already explicitly stated in SFFAC1, Objectives of Federal Financial Reporting. Explicitly requiring a consideration of the six additional qualitative characteristics might create confusion and additional complexity in the recognition criteria process. [030—Federal Auditor]

Respondents who support the alternative view in Question 10 also vary in the reasons given. Most address the applicability of the qualitative characteristics to recognition decisions. For example:

We agree with the Alternative View that language should be added to the Statement that consideration of the qualitative characteristics should be a part of recognition decisions. Readers should be informed that the decision to recognize an item must include an assessment of such characteristics as relevance and reliability. We also believe that the proposed Statement should include a description of the qualitative characteristics. As stated in Paragraph A9, if the other conceptual framework projects do not address the characteristics, they should be addressed in this Statement. [016—Federal Auditor]

We agree with the position taken in the Alternative View concerning the need for a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. Because SFFAC 1 states that the information in financial reports must have the basic characteristics of understandability, reliability, relevance, consistency, and comparability in order to effectively communicate to those who use financial information, it is reasonable that those same basic characteristics should be used in considering whether items meet the recognition criteria and should therefore be reported in the financial statements. As a result, the ED should explicitly acknowledge that the qualitative characteristics need to be considered in making decisions on whether an item meets the recognition criteria. [013—Federal Auditor]

We concur with the Alternative View concerning the need for consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. By making probability of both existence and measurability part of the recognition criteria, the integrity of the financial statements will be enhanced because of the direct impact of probability on certain qualitative characteristics of financial reporting such as reliability. [037—Federal Preparer. Respondents No. 007 and 009, both Federal Preparers, endorse this response (and all responses of No. 037) without further comment.]

Some respondents who support the alternative view refer to the need for specific qualitative characteristics, such as relevance and reliability, and others relate the need for consideration of the qualitative characteristics to the lack in the ED of existence and measurability thresholds:

[We] agree with the alternative view that the final statement should explicitly acknowledge that all of the qualitative characteristics of financial reporting should be

considered as part of determining whether an item meets the recognition criteria; i.e., meets the definition and is measurable. The ED states that determining whether an item is measurable only means that it is quantifiable in monetary units and does not explicitly discuss consideration of whether the resulting quantification, although measurable would, for example, be relevant or reliable. [021—Federal Auditor]

[Entity] concurs with the Alternative View concerning the need for consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. For example, if there is not a specific requirement for an existence and measurability threshold, the addition of more items could cause confusion. [018—Federal Preparer]

DISCUSSION AND STAFF RECOMMENDATIONS

In considering Question 10 and the responses, staff believes there are three different issues for the Board to decide:

1. Do the “Qualitative Characteristics of Information in Financial Reports” identified in SFFAC 1 (pars. 156 through 164) apply to all information in federal financial reports, including reported information guided by the proposed Concepts Statement on *Definition and Recognition of Elements of Accrual Basis Financial Statements* when it becomes final?

Staff believes the answer is yes, based on the following statement in SFFAC 1, par. 156:

Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics: understandability, reliability, relevance, timeliness, consistency, and comparability.*

*Footnote: For the most part, these characteristics are similar to those described by the FASB and the GASB.

The qualitative characteristics will apply to information guided by a concepts statement on Elements and Recognition unless the relevant portions of SFFAC 1 are superseded, and regardless of whether the qualitative characteristics are repeated or specifically incorporated into the new concepts statement. Staff notes that there is nothing in the proposed Concepts Statement that suggests the qualitative characteristics should *not* be considered when making recognition or any other financial reporting decisions.

Does the Board agree with the staff’s conclusion re Question 1 that the qualitative characteristics apply to all information in financial reports, including reported information guided by the proposed Concepts Statement, when it becomes final?

2. Assuming that the Board agrees with the staff’s conclusion on Question 1, the qualitative characteristics of information in financial reports identified in SFFAC 1 will apply to the concepts statement on Elements and Recognition. Should the Board nevertheless specifically state in the new concepts statement that the qualitative characteristics apply to

information guided by the concepts statement by, for example, a cross-reference to the relevant paragraphs of SFFAC 1 and/or by listing the qualitative characteristics? Or is the reference in par. 1 of the Elements ED to the consistency of the proposed concepts with the financial reporting objectives, qualitative characteristics of reported information, and reporting entity concepts established in earlier Statements of Federal Financial Accounting concepts sufficient?

The position taken in the ED is articulated in the first paragraph of the preamble to Question 10:

Members supporting the proposed Concepts Statement do not believe that repeating the qualitative characteristics in this Statement would be useful and doing so could cause confusion regarding the status and application of the characteristics. These members believe that if the application of the characteristics requires explanation, the explanation should be approached in a comprehensive manner.

This position is consistent with the FASAB's past practice of not repeating the provisions of existing concepts statements (or statements of standards) in new statements, although when appropriate, reference has been made to specific existing statements. Given that practice, there is a risk that repeating the qualitative characteristics in the proposed Concepts Statement on Elements could result in readers questioning what has changed in the qualitative characteristics that would require them to be restated. More generally, a deviation from past practice in a particular proposed statement could result in confusion about whether existing concepts and standards continue to apply when they are *not* repeated in subsequent statements or when some concepts and standards are repeated in some subsequent statements but not in others.

Staff agrees with the FASAB's established practice and notes that a similar practice has been followed by the FASB and the GASB. Staff believes that to waive that practice in one statement would be confusing and would beg the question as to how readers would interpret the waiver and its presence or absence in future statements. The Board may wish to consider changing the practice for all future statements—that is, repeating in new statements key provisions of existing statements that continue to apply. However, staff believes that careful consideration should be given to the impracticality of repeating existing requirements in multiple statements of concepts and standards and the risk of readers concluding that requirements that are not repeated have been superseded or do not apply to issues covered by the new statement.

Staff recommends that the Concepts Statement on Elements should *not* include a repeat of the qualitative characteristics or of their applicability to information in financial reports. Does the Board agree?

3. If the Board *disagrees* with the staff recommendation for Question 2 and concludes that a specific reference to the applicability of the qualitative characteristics should be included in the Elements Concepts Statement, there is an additional issue to decide. Should the reference be to the applicability of the qualitative characteristics to *all* information in financial reports, consistent with the discussion in SFFAC 1? (See par. 156 quoted under Question 1 above.) Or should the reference be specifically to a requirement to consider “the need for a consideration of the qualitative characteristics of financial statements as part

of determining whether an item meets the recognition criteria,” as proposed by members with an alternative view? (See Question 10 of the Questions for Respondents to the ED.)

Staff notes that the discussion of the qualitative characteristics in Chapter 6 of SFFAC 1 refers to *information* in financial reports and financial reporting in general. This is true not only of the identification of the “basic characteristics” of information in financial reports in par. 156, but also of the discussion of each of the six characteristics that information must have—understandability, reliability, relevance, timeliness, consistency, and comparability—in the remaining paragraphs 157 through 164. There is no requirement or discussion of applicability to *specific items* of information or *specific decisions*. Similarly, in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, the discussion (and the title) refers to information and to the characteristics or qualities that make information useful (par. 1) and that should be sought when making choices between alternative accounting methods (par. 5). Also, the relevant section of GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, discusses the “Characteristics of Information in Financial Reporting” and refers throughout its discussion of the individual characteristics to their applicability to information in financial reporting and financial reports, rather than to specific items or decisions.

The view expressed in the FASAB, FASB, and GASB concepts statements of the role of the qualitative characteristics is the basis for some of the responses to Question 10:

We agree with the position taken in the proposed Concepts Statement. We interpret SFFAC 1 to mean that overall the information in financial reports should have those qualitative characteristics. . . [006—Federal Auditor]:

We disagree with the Alternative View that qualitative characteristics should be considered in determining whether management should recognize an item in the financial statements. The characteristics in SFFAC 1 relate to the statements taken as a whole. We don’t believe these necessarily relate to whether or not individual components are recognized in the financial statements. [027—Federal Auditor]

On the other hand, some respondents believe that the qualitative characteristics should be applied to items being considered for recognition—for example:

We agree with the Alternative View that language should be added to the Statement that consideration of the qualitative characteristics should be a part of recognition decisions. Readers should be informed that the decision to recognize an item must include an assessment of such characteristics as relevance and reliability. . . [016—Federal Auditor]

We agree with the position taken in the Alternative View concerning the need for a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. Because SFFAC 1 states that the information in financial reports must have the basic characteristics of understandability, reliability, relevance, consistency, and comparability in order to effectively communicate to those who use financial information, it is reasonable that those same basic characteristics should be used in considering whether items meet the recognition criteria and should therefore be reported in the financial statements. As a result, the ED should explicitly acknowledge that the qualitative characteristics need to be

considered in making decisions on whether an item meets the recognition criteria.
[013—Federal Auditor]

Staff believes that because the qualitative characteristics apply broadly to all information in financial reports, they also apply—when appropriate—to the narrower concept of information generated by, for example, recognition decisions. (Staff indicates “when appropriate” because it is questionable whether or how qualitative characteristics such as timeliness and comparability would be applied to individual recognition decisions.) Indeed, in discussions during the development of the ED, the Board concluded that qualitative characteristics such as reliability (e.g., for recognition an item should be reliably measurable) should not be specified in the Concepts Statement on Elements because they already apply to all reported financial information under SFFAC 1.

Because the broader context of the qualitative characteristics incorporates the narrower one, staff believes it is unnecessary and potentially confusing to associate the qualitative characteristics specifically with recognition decisions. Moreover, to specifically refer to recognition and not to other forms of financial reporting implies a limitation on the intent of SFFAC 1 with respect to the applicability of the qualitative characteristics. The “information in financial reports” which, according to SFFAC 1 and the FASB and GASB concepts statements, should have the qualitative characteristics includes notes and required supplementary information as well as information on the face of the financial statements. The proposed Concepts Statement on Elements and Recognition also distinguishes between definition and recognition and between recognition and notes/other disclosures. If the Concepts Statement specifically requires the application of the qualitative characteristics to recognition issues, would that be interpreted as meaning the characteristics do not apply to disclosure and other issues of financial reporting such as presentation of information?

As recommended above in Question 2, staff believes that the Concepts Statement on Elements should *not* include a repeat from SFFAC 1 of the qualitative characteristics or of their applicability to information in financial reports. *Does the Board agree?*

If the Board does *not* agree and concludes that the Concepts Statement *should* include a requirement to apply the qualitative characteristics, then staff recommends that the requirement be expressed in terms of *information in financial reports*, consistent with the language in SFFAC 1, rather than with specific reference to the recognition criteria. *Does the Board agree?*

4. Assuming that the Board decides not to include in the Concepts Statement a repeat of the qualitative characteristics and their applicability, staff recommends the issue be clarified in the final Concepts Statement. A brief comment could be provided in the Basis for Conclusions. Alternatively—or in addition—paragraph 1 of the Concepts Statement could be amended to read as follows: (New language is underlined; footnote is omitted.)
 1. This document is a conceptual statement that establishes definitions and recognition criteria for elements of accrual-basis financial statements of the federal government and its component entities. The concepts it contains are consistent with and do not alter the financial reporting objectives, qualitative characteristics of reported information, and

reporting entity concepts established in earlier Statements of Federal Financial Accounting Concepts (SFFAC).

Does the Board agree with the staff's recommended addition to paragraph 1?

Question 10 of the Questions for Respondents

10. SFFAC 1, *Objectives of Federal Financial Reporting*, par. 156, states that “Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics: understandability, reliability, relevance, timeliness, consistency, and comparability.” These six characteristics are defined in SFFAC 1 and are not altered by this Statement. Members supporting the proposed Concepts Statement do not believe that repeating the qualitative characteristics in this Statement would be useful and doing so could cause confusion regarding the status and application of the characteristics. These members believe that if the application of the characteristics requires explanation, the explanation should be approached in a comprehensive manner.

The members expressing an alternative view point out that the proposed Concepts Statement does not include a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. Members with an alternative view believe that the ED should require a consideration of all of the qualitative characteristics of financial reporting in determining whether an item meets the recognition criteria; i.e., meets the definition and is measurable. In the view of these members, the lack of a consideration of the qualitative characteristics in determining whether an item meets the recognition criteria will likely result in the recognition of items that do not meet the qualitative characteristics (e.g., not relevant or reliable.) (See Appendix A: Alternative Views, par. A7.)

- a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria? Please explain the reasons for your position.



Federal Accounting Standards Advisory Board

November 6, 2006

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Conceptual Framework: Elements.**
Applicability of Current Law—TAB G—Paper 2

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Question No. 3 in the Questions for Respondents included in the Elements Exposure Draft (ED) issued in June 2006 asked whether respondents agree with “the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the potential effect of the government’s ability to change laws on the recognition of a liability.”

To place the question in context, the first paragraph of the preamble to Question 3 explains the position taken in the proposed Concepts Statement, namely that to meet the definition of a liability the federal government’s contract or other agreement to provide assets or services to another entity must be based on *existing* conditions, including current law, because an essential characteristic of a liability is that the government has a *present* obligation, even if conditions may change before settlement is due. The second paragraph of the preamble explains that members with an alternative view believe that the government’s power to modify the law to change or withdraw future benefits related to non-exchange transactions could affect the existence of a present obligation . . . and, in some instances, may preclude recognition of a liability. The complete text of Question 3, including the preamble, is at the end of this memo.

RESPONSES

As reported in the staff summary of responses presented at the September 2006 FASAB meeting, 19 respondents (6 federal auditors, 1 non-federal auditor, 5 federal preparers, and 7 non-federal other) say they support the position in the proposed Concepts Statement and 7 respondents (3

federal auditors, 3 federal preparers, and 1 non-federal other) say they support the alternative view. An additional four respondents partially support each alternative; one other respondent advocates note disclosure of both positions and one respondent does not answer the question. These are summary groupings of the responses and the reasons given by respondents vary, although most of them focus on the reasons given in the two parts of the preamble to Question 3.

Respondents who support the ED position generally give the reasons included in the first paragraph of Question 3 or refer to the basic principles of accounting to support their response. Some refer to passages from the ED or to the FASAB's position in existing pronouncements. The following responses are illustrative of the main points made:

We agree with the position taken in the proposed Concepts Statement. The balance sheet is a point in time picture of assets, liabilities and net position as of a given day. All entities (government and commercial) face the possibility of change in the value of assets and liabilities due to changes in the environment. The COSO model, integrated in government financial reporting through the Government Accounting Office's use of it in providing standards for internal control in governmental financial reporting, clearly requires consideration of regulatory factors in measurement and reporting of transactions through the financial statements. Due to the sweeping ability of government to change laws and effect future obligations, discussion of such items would make the financial statements only slightly representative of the future obligations of a component entity's obligations of as a particular date. The balance sheet and income statement should provide as comprehensive an outlook of the net position and activities of an entity as possible as of a given point in time and period. Also, the alternative view would require one to place probabilities on changes in laws across large periods of time. It is highly improbable that could be done with any level of reliability as political climates and electorates change over time. [030—Federal Auditor]

We agree with the proposed Concepts Statement and do not agree with the Alternative View. Our financial statements are representations of the financial condition of the government from a specific point in time. In order to be useful and reliable it is necessary to produce these statements based on current law, not on the possibility of a law changing in the future. Financial statements should provide the information needed to assess whether current law needs to be modified. In addition, adopting the alternative view approach could have adverse effects on many items other than social obligations. Many current liabilities are estimates based on current law, which will possibly change in the future, such as environmental liabilities. Proposing that such items may not be an obligation because a law may change in the future could result in an increase in off-balance sheet liabilities. Additionally, there are a number of things the government could do to eliminate their responsibility for liabilities, even if the probability of such action is, at best, remote (change laws, conquer nations, incarcerate individuals, simply refuse to acknowledge the debt). Shall we then remove all liabilities from the Balance Sheet based on these unforeseen events? Furthermore, this alternative concept could be applied to assets as well as liabilities, in that the government has the power to claim assets and resources that could result in misrepresentation if there is no basis of a past event or transaction that results in the ability to recognize the asset or resource. [028—Federal Preparer]

We agree with the position taken in the proposed Concepts Statement paragraph 44, that a liability must be based on “existing conditions, including current law” and that “the government’s power to change existing conditions does not preclude what otherwise would be a present obligation and recognized as a liability.” The determination of whether a present obligation and liability exist should be based on the known conditions, and current law in effect, at the time of the determination and not on future speculative or possible changes in law. Considering the government’s ability to change the law, which is the position of the alternative view, may cause agencies to consider an additional element of uncertainty in making their determinations regarding whether a present obligation exists. The consideration of that uncertainty may cause agencies not to recognize a liability and therefore understate the government’s responsibilities and decrease the reliability and usefulness of the information reported in the financial statements. [013—Federal Auditor]

Paragraph 33 of the exposure draft states, “Implicit in the definition and essential characteristics of assets is that the event giving rise to the government’s ability to control access to the economic benefits or services embodied in a resource must have occurred. The government’s intent or ability to acquire a resource in the future does not create an asset. For the resource to qualify as an asset, the government already must have acquired the resource or otherwise obtained access to the resulting benefits or services to the exclusion of other entities, for example, the mere existence of the government’s power to tax is not an asset because, until the government has exercised that power by imposing a tax and has access to benefits by virtue of completion of a taxable event, no event has occurred to generate resources and there are no resulting economic benefits that the government can control and use in providing programs and services.”

This should apply to government obligations as well. For the obligation to no longer qualify as a liability, the government must already have abandoned the obligation or otherwise revoked access to the promised benefits or services to the entitlements, for example, the mere existence of the government’s power to cancel an obligation does not cancel a liability because, until the government has exercised that power by canceling a benefit and has denied access to benefits by virtue of completion of the canceling event, no event has occurred to reduce obligations and there are no resulting economic benefits that the government can control and use in providing programs and services.

The FASAB should not attempt to anticipate the action or intent of future governing bodies by assuming a future governing body will change laws. A seated governing body should not be able to hide its accountability for establishing or increasing obligations because a future governing body may change the laws that established or increased the obligations. Conversely, the public should be informed if a seated governing body reduces or eliminates existing obligations by changing current laws. Governing bodies have the ability to include provisions in current law that would increase, eliminate or reduce benefits or services in the future. Therefore if it was the intent of past and current representatives of the citizenry to increase, eliminate or reduce promised benefits or services in the future, then there would be such provisions in current law. [022—Non-federal Other]

[Entity] agrees with the position taken in the proposed Concepts Statement. [Entity] believes that financial reports should be based on all relevant information that exists at that time, within the context and constraints of existing conditions and current law. [Entity] believes that any changes in conditions or current law that affect financial reporting should be dealt with at such time when the conditions or law changes.

[Entity] concurs with SFFAC No. 2, paragraph 84, which states "...Also, because the Federal Government is a sovereign entity, it can abrogate at any time many of its liabilities arising from other than contracts. This does not, however, eliminate the existence of, and therefore the need to report, liabilities incurred by the reporting entity." [Entity], therefore, is concerned with the alternative view that the government's power to modify the law to change or withdraw future benefits may sometimes preclude recognition of a liability. [Entity] believes that a liability should be recorded based on current conditions and current law. [023—Federal Preparer]

We strongly agree with the position taken in the proposed Concepts Statement concerning the potential effect of the government's ability to change laws on the recognition of a liability. If and until the Government changes the law, the financial statements should reflect the current state of affairs. OMB Circular A-136 specifically requires Federal agencies to disclose the Government's ability to change laws on the recognition of a liability within the summary of significant policies of the financial statement footnotes. This footnote clearly discloses the Government's ability to change law and we believe no additional discussion is needed in the Concepts Statement. [027—Federal Auditor]

Respondents who support the alternative view in Question 3 generally echo the alternative view's reference to changes in future benefits or otherwise focus on their view that social benefit obligations are different in nature from other obligations. For example:

Due to the fact that the Federal government has the right to alter scheduled benefits in any manner at any time, [Entity] supports the alternative view that the government's power to change laws affects the existence of a present obligation.

Additional Comment: [Entity] does not support FASAB's position contained in the exposure draft because the definition of a liability would most likely require that future-scheduled social insurance obligations be reported as liabilities on both agency and governmentwide financial statements.

[Entity] does not believe that future social insurance obligations are liabilities because they are neither contractual commitments nor present obligations of the Federal government. In addition, benefits for individuals are not directly tied to taxes they have paid, meaning that benefit entitlements are not exchange transactions. Further, [Entity] does not consider future-scheduled social insurance obligations as measurable from an audit perspective. [018—Federal Preparer]

We agree with the position taken in the Alternative View. Paragraph 61 of the Concepts Statement, which is not part of the Alternative View, states that, "Measurement considerations also may result in postponing recognition of some assets or liabilities until their future outcomes become less uncertain or their measures become more reliable." Long-term social insurance benefits could be considered uncertain since there is on-going discussion regarding changes that are needed to the social security program and, as GAO has pointed out on numerous occasions, the program at its current benefit levels is unsustainable in the long-term. [006—Federal Auditor]

. . . [W]e question the reasoning behind the proposed change of the definition of a liability. The nature of the federal government is truly unique, with characteristics and powers that no other entity—individual, corporation, or sub-national government—possesses. . . Specifically, the federal government—and the federal government alone—

has the power to alter unilaterally its promises in the future. Stated another way using some of the language of the ED, the federal government has the power to change unilaterally a present obligation. No other entity can do this, yet the ED would use the same concept—a “liability”—to describe these transactions as are used to describe much different kinds of transactions made by other entities that do not have the powers of the federal government.

My point here is not to say that these transactions don’t belong somewhere in the federal government’s financial statements. It is only to say that classifying these transactions the same as private sector liabilities is **wrong**; they are different and deserve a special classification—perhaps as “social obligations” or some other name, and perhaps as supplemental information to the financial statements, but not as “liabilities”. The Executive Summary of the ED states that the Board “anticipates that the guidance in the Concepts Statement would enhance the understandability, consistency, and comparability of financial reporting”. We suggest that implementation of this new concept as stated in the ED would do exactly the opposite: confuse users of financial statements by leading them to believe that the liabilities reported for certain federal transactions have the same status as liabilities reported for private entities.

Other . . . countries have also wrestled with the issue of how to classify transactions that are unique to the federal government, but we are not aware of any that have decided to lump the federal government’s “social obligations” in the same category as private liabilities. In fact, all federal governments that we are aware of have *explicitly* decided not to call federal “social obligations” liabilities. [017—Non-federal Other]

One group response from federal preparers reports different positions among the group members and does not take a single position, and one group member appends a comment that disagrees with the alternative view. Two other federal preparers (Nos. 007 and 009) endorse the group response with no further comment, as they did in response to all the other Questions for Respondents.

Due to the fact that the federal government has the right to alter scheduled benefits in any manner at any time, some members support the alternative view that the government’s power to change laws affects the existence of a present obligation. However, some members do believe that the presentation of obligations should be based upon information known at the time of preparation and not effected [*sic*] by possible changes in law. All members have not been given the opportunity to judge the possibility of alternative approaches to the presentation of these unusual elements and we hope this project can include those possibilities.

Some members have stated an entity’s balance sheet provides a snap shot of its financial position at a specific point in time. In order to provide open and full disclosure and accurately present the financial position of an entity at that given point in time, financial statements must be based on present laws, regulations, and generally accepted accounting principles regardless of whether or not that position may change in the future. Providing this full and open disclosure allows stakeholders to respond in a manner that could improve the future financial position of the entity (i.e. force change in current laws and regulations that may increase assets or reduce obligations of the Federal government).

Additional Comment (in supporting letter attached to #037). The only exception noted was found in A10 [par. A10 of the Alternative View] concerning present obligations. We noted that the ability of Congress to redefine future obligations is not measurable with any degree of accuracy. In the observance of the principle of conservatism, I express a

dissenting opinion of the concept that changes in law “may provide additional evidence about whether a present obligation exists”. We note that evidence “unless founded” in quantifiable measurable terms should not be considered present obligations. [037—Federal Preparer]

Finally, a few respondents who say they support the alternative view do not limit their consideration to Congress’s ability to change the law affecting non-exchange transactions but refer to liabilities in general. For example:

I agree with the alternative view that the government’s power to modify the law at any time and in any way affects the existence of a present obligation. The exposure draft states “the federal government is governed by and operates in a framework of laws”. The primary document that provides that framework, the U.S. Constitution, gives Congress the power to change existing law. It is often said that one Congress cannot bind another. To state that present law should be considered but ignore the fact that the law can be changed at will is contradictory. [033—Federal Preparer]

DISCUSSION AND STAFF RECOMMENDATIONS

Staff has included ample excerpts from the responses to Question 3 because they cover a variety of significant considerations in deciding the issue. The completeness of some of the responses is testimony to the strength of belief.

The position of the ED on the issue of the potential effect of the ability of Congress to change the law follows the basic principles of accounting and received substantial support from the respondents to the ED. In accordance with the basic principles, for an item to be recognized (or disclosed) as an asset, liability, revenue, or expense the transaction or other event giving rise to that item must have occurred. Thus, there should be no consideration of reducing or ignoring an obligation that meets the definition of a liability on the grounds that Congress might in the future change the law in a manner that would affect the obligation in question. Financial reporting focuses on the situation at the reporting date; that situation incorporates the laws currently in effect and does not consider the potential for future changes. Briefly stated, accounting and financial reporting are “event driven.” If an item meets the definition of an asset or liability at a particular date, it is an asset or liability regardless of possible future changes in the law. It continues to be an asset or liability until a transaction or other event (including a change in the law) occurs that affects the existence or amount of the asset or liability. This point is made in the ED in pars. 34 (assets) and 48 (liabilities). Events that might cause a *future* change in the existence or amount of an asset or a liability include a change in the law that grants the benefits at point or that specifies the formula or timing of distribution of the benefits. However, these potential future changes would not affect the reporting of assets and liabilities in the financial statements until the changes came into force.

The alternative view (AV), that potential future changes in the law could or should affect the reporting of liabilities (and, presumably, assets) before the change occurs, was discussed at several meetings concerning the definition and recognition of liabilities. The Board concluded that the current law must govern when considering the applicability of the definitions. Moreover, it should make no difference whether the transaction or other event giving rise to elements is exchange or non-exchange in nature. For that reason, no distinction is made in the Concepts

Statement on Elements between the two kinds of transactions. Whether a transaction or other event is exchange or non-exchange does not affect the definitions of elements or the applicability of the recognition criteria.

Interestingly, some of the respondents to Question 3 refer to the AV as applying to all transactions or they question why it would apply only to non-exchange transactions. Staff believes that it would be difficult for the Board to justify making an exception to the applicability of the proposed liability definition for obligations under non-exchange transactions. The issue for both kinds of transactions under the Elements ED is whether an item does or does not meet the definition of a liability. The difference between non-exchange and exchange transactions lies in the identification of the point at which the liability is incurred, and not whether a potential future change in the law should affect the recognition of obligations that currently exist.

Staff believes that the responses to the ED (Question 3) amply support the position taken in the ED. The AV focuses on non-exchange transactions and advocates consideration of the possibility that Congress will change the law as justification for not acknowledging—or justification for reducing the amount of—an item that otherwise meets the definition of a liability or other element of the financial statements. The focus of the AV and of most of the responses that support the AV is on social programs (e.g., social insurance) and the benefits resulting from them. This suggests a concern for the reporting of liabilities under those programs that is greater than any concern for reporting liabilities under other programs. Yet, the proposed definition of a liability and the recognition criteria are the same for all programs. As respondents that support the ED point out, the fact that the law may change in the future does not remove or reduce an obligation that exists at the financial statement date, which is a liability if it meets the definition of a liability. And, as proposed in the ED, if the liability meets the proposed recognition criteria, it should be reported in the balance sheet. Notwithstanding that conclusion and as one respondent points out, the possibility of a change in the law that might affect the existence or amount of that liability can (or should) be disclosed.

Staff does not find arguments in the responses that favor the AV position that have not been amply considered by the Board prior to issuing the ED. Moreover, staff agrees with many of the respondents that support the ED position that items reported in the financial statements as liabilities or assets, whether they result from non-exchange or exchange transactions, should not be affected in existence or amount by potential future changes in legislation. Those potential changes can (or should) be disclosed. Therefore, **staff recommends no change to paragraph 44, as drafted in the ED. Does the Board agree?**

A brief comment may be appropriate in the Basis for Conclusions to the final Concepts Statement on the responses to Question 3 and the Board's conclusions.

Question 3 of the Questions for Respondents

3. The proposed Concepts Statement addresses the government's ability to change laws in the future as stated in paragraph 44 as follows:

To meet the definition of a liability, the federal government's contract or other agreement to provide assets or services to another entity must be based on *existing* conditions, including current law, because an essential characteristic of a liability is that the government has a *present* obligation, even if conditions may change before settlement is due. For example, the Congress may change a law under which the federal government has incurred a present obligation and erase the obligation or otherwise enable the government to avoid settlement. Alternatively, the government may be able in the future to renegotiate the obligation with the payee or recipient of the promised services. However, liabilities and all other elements of accrual-basis financial statements are based on transactions or events that already have occurred. The government's power to change existing conditions does not preclude what otherwise would be a present obligation and recognized as a liability.

Members with an alternative view believe that the government's power to modify the law to change or withdraw future benefits related to non-exchange transactions could affect the existence of a present obligation. Consequently, these Board members believe that the government's ability to change the law may provide additional evidence about whether a present obligation exists and, in some instances, may preclude recognition of a liability. Therefore, they disagree with paragraph 44. (See appendix A, page 29.)

- a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the potential effect of the government's ability to change laws on the recognition of a liability? Please explain the reasons for your position.



Federal Accounting Standards Advisory Board

November 6, 2006

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: Conceptual Framework: Elements—TAB G

NOTE: FASAB staff prepares memos and other materials to facilitate discussion of issues at Board meetings. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

Materials for the Board's consideration in TAB G comprise the following:

1. Paper 1: The Qualitative Characteristics of Accounting Information. A review of the issue, including responses to Question 10 in the Elements ED, and staff recommendations.
2. Paper 2: Applicability of Current Law. A review of the issue, including responses to Question 3 in the Elements ED, and staff recommendations.
3. Additional Item for the Board's consideration:
Draft response from Ms. Comes to Mr. David Bean, Director of Research and Technical Activities of the GASB, concerning the GASB's request for a meeting among the technical staff, directors, and chairmen of the GASB and the FASAB to consider a more coordinated effort to define elements of financial statements. The GASB's letter was reviewed by the GASB Board and signed by Mr. Bean. A copy is attached to the draft letter along with the GASB Elements ED for reference.



Federal Accounting Standards Advisory Board

November 6, 2006

Mr. David Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

Thank you for your letter of August 31, 2006. The Board will benefit greatly from the comments you offered on our Exposure Draft of a proposed Statement of Federal Financial Accounting Concepts, *Definition and Recognition of Elements of Accrual-Basis Financial Statements*. You expressed a desire for a meeting among the technical staff, directors and chairmen of the Governmental Accounting Standards Board (GASB) and the Federal Accounting Standards Advisory Board (FASAB) to consider a more coordinated effort to define elements of financial statements. We agree with the suggestion that "substantive differences on issues as fundamental as financial statement elements definitions for governments in the United States should be minimized when possible." However, we wish to note that our two Boards diverge in at least two critical areas; making coordination quite difficult.

The first divergence is with respect to whether the definitions of revenues and expenses should be derived from definitions of assets and liabilities. The FASAB proposed element definitions rely on asset and liability to derive definitions of revenues and expenses. The GASB definition purports to depart from this foundation by defining all elements except for net assets independently of each other by their inherent characteristics. Elements are instead defined in terms of "resources."

We believe the GASB approach obfuscates the inherent characteristics of each element. For example, in par. 24, the consumption of net resources is defined as "a using up of net resources" and is elaborated on as follows:

A consumption of net resources results in (a) a decrease in assets in excess of any related decrease in liabilities or (b) an increase in liabilities in excess of any related increase in assets.

If a using up of resources results only in changes in assets and liabilities, why is the term "resources" needed in the definition? A simpler explanation can be had by direct reference to assets or liabilities; the approach taken by the FASAB. It appears that the GASB's reliance on "resources" as an inherent characteristic of all elements is simply a means to avoid using the terms "assets" and "liabilities" in the definitions.

We generally agree with the GASB that the operating statement and balance sheet are of equivalent importance and, in fact, some believe the Statement of Net Cost (an operating statement in the federal model) is of greater importance. However, we do not believe that defining operating statement elements in terms of real world phenomena – assets and liabilities – alters the relative importance of the two types of financial statements. To the contrary, in light of the core notion that the financial statements articulate, we believe element definitions that assist users in understanding the relationships between the operating (flow) statements and balance sheet (stock statement) are helpful. Ultimately, the usefulness of the financial statements will be enhanced by greater understanding of these relationships.

The second divergence relates to scope. The FASAB concluded early on that recognition criteria should be included within the scope of its project. At this time, we plan to include recognition criteria in our final concepts statement. We are concerned that this difference in scope will hinder coordination of efforts between the two boards.

Some may believe that the “deferred inflow” and “deferred outflow” elements represent a third divergence. However, we are unsure of the GASB’s intended meaning of these terms. Thus, it is difficult to assess whether this is a true difference or simply a type of asset or liability (per FASAB definitions) that GASB wishes to establish as a separate element.

Despite the above reservations, we are available to meet to discuss coordination of efforts. If you believe a meeting would be useful, please contact me to discuss the timing.

Sincerely,

Wendy M. Comes

August 31, 2006

Ms. Wendolyn M. Comes
Executive Director
Federal Accounting Standards Advisory Board
441 G Street, NW, Suite 6814
Washington, DC 20548

Dear Ms. Comes:

Thank you for the opportunity to offer comments on the Exposure Draft of a proposed Statement of Federal Financial Accounting Concepts, *Definition and Recognition of Elements of Accrual-Basis Financial Statements*. This response was prepared by the Governmental Accounting Standards Board's (GASB) staff. A draft of this response was provided to individual GASB members for their input. Official positions of the GASB are determined only after extensive due process and deliberation.

As the Financial Accounting Standards Advisory Board (FASAB) members and staff are aware, the GASB released in August its own Exposure Draft of a proposed Concepts Statement, *Elements of Financial Statements*. The focus of our response to the Questions for Respondents is to highlight what we perceive to be some of the differences that exist between the two proposals and why the GASB chose its course of action. We realize that the FASAB staff prepared a memo before the release of the FASAB Exposure Draft that compared the two documents at that point in time; however, we believe that a comparison from the GASB perspective may prove useful during the FASAB's redeliberations.

Question 1 (a)—Should the definitions of assets and liabilities derive from their fundamental or essential characteristics?

Response—We agree that definitions of assets and liabilities should be derived from inherent characteristics (GASB's term). Although some standards setters in the past have used other approaches, the inherent characteristics approach has proven to be more conceptually based and also provides clearer guidance for future standard setting.

Question 1 (b)—Should the definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities?

Response—We do not agree that the definitions of revenues and expenses should be derived from definitions of assets and liabilities. We believe that the "derived from" approach is inherently flawed because it places emphasis, either intended or unintended, on the statement of financial position over the resource flows statement. As noted in the

Basis for Conclusion of the GASB's Elements of Financial Statements Exposure Draft, "The Board believes that these two statements [statement of financial position and resource flows statement] are of equivalent importance and that the elements of neither statement should be defined solely as changes in or residuals of elements in the other statement. For example, the Board believes that the resource flows statement should present information that can be used to assess the financial performance of government, rather than strictly presenting increases and decreases in the assets and liabilities presented in the statement of financial position."

Question 1 (c)—If an item meets the definition of an asset is it an asset even if it is not recognized in the body of a financial statement because, for example, it is not measurable or its amount is not material?

Response—We believe that if an item meets the definition of an asset it is an asset. Issues such as measurability and materiality are considerations in the recognition process.

Question 2 (a)—Are there additional elements of accrual-basis financial statements that should be defined in the Concepts Statement? If so, what are they and what are their essential characteristics? Alternatively, what are they and how would you define them?

Response—Yes. As noted in paragraphs 31-34 of the GASB's Exposure Draft, we believe that two additional financial statement elements are necessary to reflect the inherent nature of many government activities, which are period based.

The GASB has proposed an additional element—*deferred outflows of resources* that should be reported in a statement of financial position. We believe that this element should be defined as the "consumption of net resources by the entity that is applicable to a future reporting period." The GASB proposed that the inherent characteristic of being applicable to a future reporting period is parallel to the characteristic of applicable to the reporting period which is an inherent characteristic of the GASB's proposed definition of *outflows of resources* (expenses) with the exception that for a deferred outflow of resources, the outflow is applicable to a future reporting period rather than to the current reporting period.

The GASB also proposed another element—*deferred inflows of resources* that should be reported in a statement of financial position. We believe that this element should be defined as the "acquisition of net resources by the entity that is applicable to a future reporting period." The GASB proposed that the inherent characteristic of being applicable to a future reporting period is parallel to the characteristic of applicable to the reporting period which is an inherent characteristic of the GASB's proposed definition of

outflows of resources and *inflows of resources* (revenues) with the exception that for a deferred inflow of resources, the inflow is applicable to a future reporting period rather than to the current reporting period.

Question 2 (b)—Do you agree or disagree that there are additional elements that need to be defined? If you agree, what are the essential characteristics of these elements?

Response—We do not believe that addressing items such as certain intangible resources, long-term social obligations, and other commitments require different or additional elements in accrual-basis financial statements. Although not addressed in the GASB's Exposure Draft, we do not object to items such as social benefit obligations being reported in separate statements as part of the basic financial statements. Even when obligations do not meet the definition of a liability and would not be included as a component of accrual-basis financial statements, information on those activities could be considered essential in assessing the overall economic condition and financial sustainability of a government.

Question 3—Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the potential effect of the government's ability to change laws on the recognition of a liability?

Response—The GASB addressed this issue by separating liabilities into two groups—those arising from exchange transactions and those arising from nonexchange transactions. Because exchange transactions, for the most part, are based on a legally enforceable agreement, the issue of whether the government can change the law to alter the liability is moot. For nonexchange transactions, however, circumstances are different. We recognized that the notion of legally enforceable is less clear in these circumstances. We therefore described an equivalent to legally enforceable—when *all* eligibility requirements have been met. In addition to recognizing that liabilities arise through legal obligations, the GASB's Exposure Draft also provides for the possibility that liabilities might arise in circumstances when social, moral, or economic consequences leave the entity little or no discretion to avoid a sacrifice of resources or future resources.

Question 4 (a)—Do you agree that these two characteristics are essential characteristics of all federal government assets?

Response—We agree that assets are resources that embody economic benefits or services and that control is an essential characteristic; however, we have a concern about the use of the word "can" when used in conjunction with control. We believe that the use of

“can” likely will be misinterpreted to encompass future events. Given the broad range of powers afforded governments in the United States, governments “can” control many assets; however, that control can only be exercised based on some additional event occurring. We do not believe that it was the FASAB’s intent to consider a resource that could be controlled as an asset. We believe that the GASB’s proposed definition “Assets are resources that the entity presently controls” with adequate clarification of the terms “resources” and “control” addresses those concerns.

Question 4 (b)—Are there any *additional* characteristics that are *fundamental* or *essential* to all federal government assets?

Response—No. See response to 4 (a).

Question 5 (a)—Do you agree or disagree that these two characteristics are essential characteristics of all federal government liabilities?

Response—We agree with the first characteristic, present obligation; however, we believe that the second characteristic (that is, the timing of the settlement) is an aspect of the first characteristic, rather than an additional characteristic.

Question 5 (b)—Are there any *additional* characteristics that are *fundamental* or *essential* to all federal government liabilities?

Response—No.

Question 6 (a)—Do the definitions of assets and liabilities adequately convey the essential characteristics from which they are derived? If not, how would you modify the definitions?

Response—Respectfully, we believe that the GASB’s proposed definitions more clearly capture the inherent characteristics found in the government environment in the United States.

Question 6 (b)—Do the definitions of net position, revenues, and expenses adequately convey their relationship to assets and liabilities? If not, how would you modify the definitions?

Response—As noted in the response to Question 1 (b), we believe that the definitions of revenues and expenses should be defined based on each element’s own inherent characteristics. The definition of net position does adequately convey its relationship to assets and liabilities.

Question 7—Are there *other* criteria that should be established as conditions for recognition? If so, what recognition criteria would you add or delete?

Response—The GASB has only developed limited recognition criteria at a conceptual level at this point in time (project deliberations on a recognition and measurement attributes concepts project are scheduled to begin in October); therefore, it would be premature to comment at this time.

Question 8—Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element?

Response—We do not believe that there is a need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element.

Question 9—Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for an explicit requirement for an assessment of probability and a probability threshold when determining whether an item is measurable?

Response—As noted in the response to Question 7, the GASB has only developed limited recognition criteria or examined measurement issues at a conceptual level at this point in time; therefore, it would be premature to comment at this time.

Question 10—Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria?

Response—As previously noted the GASB has only developed limited recognition criteria at a conceptual level at this point in time; therefore, it would be premature to comment at this time.

Concluding Comment

Although both the GASB and the FASAB operate as independent bodies with individual projects and project timetables, we believe that substantive differences on issues as fundamental as financial statement elements definitions for governments in the United States should be minimized when possible. Even though both Boards have now issued

Ms. Wendolyn M. Comes
August 31, 2006
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proposed concepts statements, we believe that it is not too late for a meeting between the Chairmen, Directors, and project staffs to determine if a more coordinated effort has an opportunity for success.

We are willing to meet at a time and place that is convenient for the FASAB to discuss this response and the potential of working more closely together as both Elements of Financial Statements projects are finalized.

Thank you for considering our comments.

Sincerely,

David R. Bean